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McGraw-Hill Construction Information Group

1988 Dodge/Sweet's Construction Outlook

First Update
February 1988

Another Notch Down

The stock market meltdown, coming as it did only days before the release of the *1988 Construction Outlook*, threatened last fall's carefully developed analysis with instant obsolescence. Fortunately, it didn't turn out that way. The task of this *First Update* is to sort out what has changed as a result of the crash, and what hasn't.

The risks that were suddenly added to the *1988 Outlook* seemed awesome at the time. Black Monday could have precipitated a liquidity crisis leading to the collapse of the already shaky commercial real estate market. But it didn't. It could have provoked an over-reaction by Congress to quick-fix the budget deficit with deep across-the-board spending cuts, including public construction programs. That didn't happen either. It might have paralyzed the consumer sector, causing postponement of home-buying plans and a sharp cutback in new housing starts. F. W. Dodge data show no sharp break since October in 1987's year-long decline of housing starts. Nor did sales of existing homes weaken significantly at year-end.

In what ways then, has the Wall Street event altered the short-term outlook for the construction and building products industries?

It should be remembered that the construction industry was carrying a lot of baggage into 1988 even before the stock market toppled. Among the burdens that have been slowing the pace of construction contracting since as far back as mid-1986 are: the vast surplus of vacant office and apartment space, the severe regional imbalance of construction demand, the repeal of tax incentives for commercial building, the mandate for deficit reduction, excess industrial capacity resulting from the trade gap, and–not the least of them–rising interest rates. In recognition of this accumulation of handicaps, it has been evident for some time that the long period of cyclical expansion of construction activity that began at the end of 1982 was due for reversal. October's financial shock, creating a sudden sense of loss of wealth and adding to the growing risk of general economic slowdown, reinforced vulnerabilities that were already eroding the construction market. One of the few trade-offs: a new direction for interest rates as the focus of monetary policy shifted abruptly from international to domestic problems.

For the building industry, the prospects of economic slowdown, increased budgetary restraint, and lower interest rates–all of them the fallout of the Wall Street shock–suggest that the negative pre-crash outlook for commercial building has worsened over the past few months. So, too, has the short run prospect for public works construction. However, the potential for housing and institutional building, which are the most credit sensitive parts of the construction market, may have improved a bit now that the past year's rise of interest rates has been reversed.

A tally of last year's construction contracting data reveals a two-way market: inflation nudged the 1987 value of all newly started construction to a new high of $255 billion, but *in constant dollars, contracting declined 3 percent from its 1986 peak*. It has been apparent for several months that contracting for new construction is headed for a further "real" decline of about 6 percent in 1988, and the events of the fourth quarter now require the year's potential to be downgraded by another percentage point (i.e., to minus 7 percent). Stated another way, six-sevenths of the decline now expected in 1988 would have happened without Wall Street's "help."

Nonresidential Building

Little new can be said about the geographically lopsided *office* building market as fewer and fewer areas remain viable. The main difference between 1987 and 1986 was that the North Central region joined the South and the West in the negative column, leaving only the Northeast with a gain for the year. But as office building crested and turned down in the North Central last year, the South's rate of decline slowed. After six years of retreat, office building in the Oil Patch finally appeared to be stabilizing–at a dismal level.

These divergent regional developments left last year's national total of newly started office space at a stubborn 270 million square feet–23 percent below 1985's all-time high of 350 million, but only 8 percent off the 1986 pace. A volume of newly added space this large is almost certain to raise the average vacancy rate in 1988 as work in progress is brought to completion.

If the office vacancy rate is to shrink

from its present 20-plus percent toward a more desirable 10 percent over the next few years, new construction must be reduced still further. A cutback to between 150 and 175 million square feet by 1990 is a reasonable target to permit gradually rising white collar employment to absorb the glut of vacant space. In 1988, when the Northeast will no longer be offsetting declines in other regions, total office building will recede to 225 million square feet–another step toward equilibrium.

Wholesale reductions of office staffs throughout New York's financial community illustrate how close the link between the stock market and construction demand can be. Salomon Brothers' withdrawal from the massive Columbus Circle project was not the first change of plans, and isn't likely to be the last.

Retail building (stores, shopping centers, warehouses, etc.) is once again about to demonstrate its dependence upon homebuilding as its primary source of demand, but with an added twist.

For three years (1984/85/86), housing starts held high and steady at 1.8 million units and for three years (1985/86/87), retail building was similarly high and steady, averaging 585 million square feet per year. But in 1987, the seeds of change were sown as housing starts fell back to 1.6 million units. Allowing for the normal lag, that decline of homebuilding should have a negative influence on the demand for retail facilities in 1988. There's more to it, however. Consumer spending is bound to be one of the casualties of the stock market crash and will compound the downward pull of housing. The combined effect of reduced homebuilding and weaker consumer spending points to a decline of as much as 15 percent for retail building in the year ahead to just under 500 million square feet.

Industrial construction is the "sleeper" of the nonresidential building group, and is ready to make its move. Since 1984, contracting for manufacturing buildings has not strayed far from a plateau of 150-160 million square feet per year while offices and retail building provided most of the action. It was during this period that U.S. manufacturers began to recapture their lost competitive edge by investing in cost-saving machinery and equipment while waiting for the dollar to stabilize.

By 1987, conditions were right for expansion of plant facilities as sharply rising exports began to take up slack capacity. Utilization of plant capacity, which remained frozen at 79 percent through all of 1985, 1986, and half of 1987, finally crossed the 80 percent threshold in mid-1987 and reached 82 percent by year-end–a rate which usually triggers expansion. Although any near-term increase of industrial construction is likely to be small and cautious, there has been enough structural change in the circumstances that influence this building market to warrant a breakout from recent stagnation.

Institutional building is caught up in a conflict between generally supportive demographics and occasionally supportive financial conditions. With the "under 10's" and the "over 65's" growing faster than the population as a whole, the relatively low interest rates of the past few years have given rise to a mini-boom for elementary schools and for long-term health care facilities. (For different reasons, the construction of prisons is also booming.)

The current high volume of institu-

1988 National Estimates
Dodge Construction Potentials

First Update February 1988

		1987 Preliminary	1988 Forecast	Percent Change 1988/87
Nonresidential Buildings				
Floor Area (millions of square feet)	Office Buildings	270	225	−17
	Stores & Other Commercial	580	495	−15
	Manufacturing Buildings	155	160	+ 3
	Total Commercial & Manufacturing	1,005	880	−12
	Educational	127	122	− 4
	Hospital & Health	80	76	− 5
	Other Nonresidential Buildings	158	152	− 4
	Total Institutional & Other	365	350	− 4
	Total Nonresidential Buildings	1,370	1,230	−10
Contract Value (millions of dollars)	Office Buildings	$ 22,250	$ 19,150	−14
	Stores & Other Commercial	24,500	21,600	−12
	Manufacturing Buildings	8,150	8,650	+ 6
	Total Commercial & Manufacturing	$ 54,900	$ 49,400	−10
	Educational	$ 11,875	$ 11,775	− 1
	Hospital & Health	8,600	8,400	− 2
	Other Nonresidential Buildings	14,150	13,925	− 2
	Total Institutional & Other	$ 34,625	$ 34,100	− 2
	Total Nonresidential Buildings	$ 89,525	$ 83,500	− 7
Residential Buildings				
Dwelling Units* (thousands of units)	One Family Houses	1,015	975	− 4
	Multifamily Housing	585	550	− 6
	Total Housekeeping Residential	1,600	1,525	− 5
Floor Area (millions of square feet)	One Family Houses	1,679	1,609	− 4
	Multifamily Housing	602	561	− 7
	Nonhousekeeping Residential	83	78	− 6
	Total Residential Buildings	2,364	2,248	− 5
Contract Value (millions of dollars)	One Family Houses	$ 85,975	$ 84,900	− 1
	Multifamily Housing	27,400	26,250	− 4
	Nonhousekeeping Residential	6,650	6,425	− 3
	Total Residential Buildings	$120,025	$117,575	− 2
Nonbuilding Construction				
Contract Value (millions of dollars)	Transportation Construction	$ 27,425	$ 26,450	− 4
	Environmental Construction	14,900	15,150	+ 2
	Total Public Works	$ 42,325	$ 41,600	− 2
	Utilities	$ 3,300	$ 3,500	+ 6
	Total Nonbuilding Construction	$ 45,625	$ 45,100	− 1
All Construction				
Contract Value (millions of dollars)	Total Construction	$255,175	$246,175	− 4
	Dodge Index (1982 = 100)	162	157	

*F.W. Dodge basis.

1988 Regional Estimates
Dodge Construction Potentials

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Northeast	CT, ME, MA, NH, NJ, NY, PA, RI, VT	1987 Preliminary	1988 Forecast	Percent Change 1988/87
Contract Value (millions of dollars)	**Nonresidential Buildings**			
	Commercial and Manufacturing	$11,325	$10,675	− 6
	Institutional and Other	6,850	6,225	− 9
	Total	$18,175	$16,900	− 7
	Residential Buildings			
	One Family Houses	$13,875	$13,200	− 5
	Multifamily Housing	6,375	5,700	−11
	Nonhousekeeping Residential	1,425	1,050	−26
	Total	$21,675	$19,950	− 8
	Nonbuilding Construction			
	Transportation	$ 5,125	$ 5,050	− 1
	Environmental	3,075	3,025	− 2
	Utilities	1,200	800	−33
	Total	$ 9,400	$ 8,875	− 6
	Total Construction	$49,250	$45,725	− 7

South	AL, AR, DE, DC, FL, GA, KY, LA, MD, MS, NC, OK, SC, TN, TX, VA, WV	1987 Preliminary	1988 Forecast	Percent Change 1988/87
Contract Value (millions of dollars)	**Nonresidential Buildings**			
	Commercial and Manufacturing	$18,125	$16,125	−11
	Institutional and Other	12,850	12,550	− 2
	Total	$30,975	$28,675	− 7
	Residential Buildings			
	One Family Houses	$33,825	$32,775	− 3
	Multifamily Housing	8,175	7,950	− 3
	Nonhousekeeping Residential	2,075	2,300	+11
	Total	$44,075	$43,025	− 2
	Nonbuilding Construction			
	Transportation	$10,450	$10,000	− 4
	Environmental	5,750	5,750	—
	Utilities	950	1,200	+26
	Total	$17,150	$16,950	− 1
	Total Construction	$92,200	$88,650	− 4

North Central	IL, IN, IA, KS, MI, MN, MO, NE, ND, OH, SD, WI	1987 Preliminary	1988 Forecast	Percent Change 1988/87
Contract Value (millions of dollars)	**Nonresidential Buildings**			
	Commercial and Manufacturing	$12,500	$11,150	−11
	Institutional and Other	7,125	7,175	+ 1
	Total	$19,625	$18,325	− 7
	Residential Buildings			
	One Family Houses	$16,025	$16,700	+ 4
	Multifamily Housing	5,300	4,650	−12
	Nonhousekeeping Residential	1,225	1,175	− 4
	Total	$22,550	$22,525	—
	Nonbuilding Construction			
	Transportation	$ 6,150	$ 5,950	− 3
	Environmental	3,325	3,425	+ 3
	Utilities	425	525	+24
	Total	$ 9,900	$ 9,900	—
	Total Construction	$52,075	$50,750	− 3

West	AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY	1987 Preliminary	1988 Forecast	Percent Change 1988/87
Contract Value (millions of dollars)	**Nonresidential Buildings**			
	Commercial and Manufacturing	$12,950	$11,450	−12
	Institutional and Other	7,800	8,150	+ 4
	Total	$20,750	$19,600	− 6
	Residential Buildings			
	One Family Houses	$22,250	$22,225	—
	Multifamily Housing	7,550	7,950	+ 5
	Nonhousekeeping Residential	1,925	1,900	− 1
	Total	$31,725	$32,075	+ 1
	Nonbuilding Construction			
	Transportation	$ 5,700	$ 5,450	− 4
	Environmental	2,750	2,950	+ 7
	Utilities	725	975	+34
	Total	$ 9,175	$ 9,375	+ 2
	Total Construction	$61,650	$61,050	− 1

tional building is not considered sustainable because this market has been making up for a dearth of construction in the early 1980's when municipal bond rates were prohibitively high. A more appropriate level of building for the next several years is perhaps 25 to 30 million square feet below last year's 365 million. Beginning in 1988, some settling back should be taking place to bring building closer in line with the underlying demographics of the marketplace.

Public Works Construction

After finally adjusting to last year's *erratic* Federal funding (the result of the veto of the new highway act), public works construction must now adapt to *reduced* funding, the consequence of Federal deficit reduction.

Public works construction programs have taken only a glancing blow from the deficit reduction axe. Negotiation between Congress and the Administration managed to satisfy the conditions of the Gramm-Rudman deficit targets for 1988/89 through an eleventh-hour combination of tax increases, asset sales, and benefits reductions without reaching deeply into Federal public works programs. Had it been necessary to apply the "sequestration" formula, the pro-rata share of these programs would have amounted to well over a billion dollars. Instead, the "budget summit" reduced the amount of highway/bridge funds that states may obligate in fiscal

year 1988 by $600 million (5 percent), but left DOT's mass transit funds largely intact. EPA's sewage treatment grants took a token cut of $100 million (4 percent), while the planned expansion of water resource projects by the Corps of Engineers and Bureau of Reclamation survived.

During the six-month period between the veto of the new Surface Transportation Act (October, 1986) and its eventual override (April, 1987), Federal highway funds dried up temporarily, and then surged. As a result, some 1986 highway money carried over into 1987, making last year an unusually big one for highway construction. In 1988, as things settle back to normal, a modest decline is in order. Thus, for reasons having as much to do with the legislative process as with the deficit, contracting for transportation construction (roads, bridges, and mass transit) is slated for a "real" decline of 7 percent in 1988. Inflation will limit the decline to 4 percent in current prices.

Environmental construction offers prospects for some gains as well as some losses in 1988, although the year's net total is headed for a small (2 percent) decline in constant dollars. Inflation will turn that setback into a small increase in current dollars, however. EPA's budget cut implies restricted Federal funding for waste treatment plants in the year ahead, but construction of dams, reservoirs, and river/harbor projects will be getting a lift from the late-1986 Water Resources Act which authorizes many new undertakings on a Federal/local shared basis. Weakest of all the categories in the environmental group for 1988 is water distribution systems, a type of public works construction that is closely tied to general building activity. The declining volume of housing starts since 1986 translates directly into reduced demand for water supply facilities.

The recent reversal of last year's steady climb of municipal bond rates will help state and local governments to assume a larger share of the financing of public works construction in 1988 as the Federal government pulls back its support. Local governments will be challenged even more in 1989 when the new revolving loan fund replaces EPA's construction grant program.

Residential Building

Revised 1988 forecasts of *non*residential building (−7 percent) and of public works construction (−2 percent) continue to fit the pattern of a fairly gentle cyclical decline. Housing, which makes up the remaining half of total construction contract value, is settling into a similar groove. That much was apparent before the stock market crash, and "gentle decline" is still the most credible forecast for housing in 1988.

Last October's pre-crash forecast of total housing starts in 1988 was 1,525,000–a decline of 5 percent. Multifamily building, still adjusting to several years of overdevelopment during the mid-1980's, was expected to decline for the third consecutive year to 550,000 units (F. W. Dodge basis). At the same time, one family housing, reacting to rising mortgage rates, was forecast to retreat from last year's peak volume to 975,000 units in 1988. Circumstances have changed since last October, but the numbers haven't. At least not yet.

The multifamily housing market has been out of touch with reality for most of the 1980's, and has been declining sharply since late in 1985 after starts soared to the extraordinary rate of just over 900,000 units. In the absence of tax shelters, building has fallen below 600,000 units, but still hasn't come down far enough to allow the huge surplus of vacant apartments to be absorbed. Latest data (1987:III) showed rental vacancy rates rising above 8 percent to a 20 year high!

Further declines of multifamily building–to 550,000 in 1988 and possibly below 500,000 in 1989–will be needed to balance the excesses of the mid-1980's. Even then, a vacancy problem will persist in the Southwest.

If Wall Street has altered the housing outlook for 1988, the place to look for new directions is not in the troubled multifamily sector but in the thriving one family housing market. Side effects of the collapse of stock prices include weakened consumer confidence and lower interest rates. For housing, these opposing forces amount to a trade-off.

Two independent measures of consumer attitudes are saying the same thing: confidence plummeted in November, then rebounded in December when it became apparent that the stock market's plunge had stabilized. But neither indicator showed December's strengthened confidence coming close to its pre-crash buoyancy. October 19th clearly took some momentum out of the consumer-driven economy.

Lower interest rates in 1988 are bound to entice some marginal home buyers into the market to substitute for the ones whose shaken confidence has relegated them to the sidelines. The Wall Street event brought an instant reversal of 1987's upward trend of interest rates as institutions shifted from equities to bonds. But more than that, by lowering expectations about the general business outlook for 1988, it added the weight of economic persuasion to already existing political pressure on the Federal Reserve to chart a more expansionary course for the year ahead. If confidence is gradually restored over the winter, the prospect of declining interest rates means that the middle quarters of 1988 could be good ones for homebuilders and their suppliers.

For reasons apart from the ones that seemed so compelling only a few months ago, 1988's housing outlook remains unchanged at 1,525,000 units. Allowing for modest inflation, this 5 percent decline in the number of newly built units implies only a 2 percent setback from last year's total residential construction contract value.

1988 Outlook Updated

Since last October's *Outlook*, consumer confidence has been shaken, Federal budgetary restraint has been tightened, and expectations for the economy's growth through 1988 have been lowered. At the same time, the outlook for interest rates has brightened. On balance, this mixture of favorable and unfavorable developments does not pose a serious threat to a credit-sensitive industry like construction as long as a general recession can be avoided.

Because the original *1988 Outlook* was a downer, the financial and psychological shocks of the stock market crash have not added greatly to the year's risks. Total construction contract value is now estimated at $246 billion, a decline of 4 percent from the 1987 peak of $255 billion. Two-thirds of the 1988 setback will be concentrated in commercial building.

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